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ONE ARTICLE FROM OER'S ECONOMIC INTELLIGENCE WEEKLY REVIEW ENDING 30 MARCH 1978. REQUEST ARTICLE BE PASSED TO AMBASSADOR, DCM, ECONOMIC SECTION AND OTHER WORKING LEVEL STATE OFFICERS.

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ZAMBIA: FRONTLINE STATE IN ECONOMIC TROUBLE

1. LOW COPPER PRICES AND WASTEFUL GOVERNMENT SPENDING HAVE FORCED ZAMBIA TO REQUEST EMERGENCY FINANCIAL HELP FROM THE INTERNATIONAL MONETARY FUND (IMF). UNEMPLOYMENT IS GROWING, FOOD AND CONSUMER GOODS ARE PERIODICALLY SCARCE, AND ZAMBIA HAS FALLEN MORE THAN \$500 MILLION BEHIND IN PAYMENTS FOR IMPORTED GOODS. THE ECONOMIC PICTURE IS WORSENNED BY THE DISRUPTIVE EFFECT OF THE RHODESIAN SITUATION, INCLUDING THE COSTS OF HARBORING GUERRILLAS, THE EFFECT OF CROSS-BORDER RAIDS FROM RHODESIA, AND THE DETERIORATION OF THE GENERAL BUSINESS CLIMATE IN THIS PART OF AFRICA.

2. ALL OF THESE FACTORS HAVE PUT PRESSURE ON PRESIDENT KENNETH DAVID KAUNDA IN THIS ELECTION YEAR. HOWEVER, THEY APPARENTLY HAVE NOT ALTERED HIS LONGSTANDING SUPPORT FOR HIS OLD FRIEND JOSHUA NKOMO, WHOSE RHODESIAN GUERRILLAS OPERATE FROM ZAMBIAN TERRITORY. A RHODESIAN SETTLEMENT IN ANY CASE WOULD NOT SOLVE ZAMBIA'S UNDERLYING ECONOMIC PROBLEMS, PARTICULARLY ITS DEBT PROBLEMS, UNLESS ACCOMPANIED BY LARGE INFLOWS OF FOREIGN FUNDS. ON THE OTHER HAND, AN INTENSIFICATION OF THE CONFLICT WOULD RESULT IN FURTHER SETBACKS TO THE ZAMBIAN ECONOMY AND PERHAPS EVEN TO KAUNDA'S POLITICAL POSITION.

THE DOWNSLIDE, 1974-77

3. ZAMBIA'S ECONOMIC CRISIS WAS SPAWNED DURING THE

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COPPER BOOM OF 1973-74, WHEN COPPER PRICES ON INTERNATIONAL MARKETS WENT TO A RECORD \$1.37 A POUND. THESE HIGH PRICES TRIGGERED A GOVERNMENT SPENDING BINGE, WHICH PUSHED BUDGET OUTLAYS UP BY 50 PERCENT IN TWO YEARS AND IMPORTS UP EVEN FASTER. IN 1975, HOWEVER, COPPER PRICES PLUMMETED TO 55 CENTS A POUND, LEAVING LUSAKA WITH A CURRENT ACCOUNT DEFICIT OF ALMOST \$600 MILLION, SUBSTANTIALLY MORE THAN THE SMALL COPPER-BASED ECONOMY COULD SUSTAIN. BY YEAREND 1975, THE FOREIGN DEBT HAD RISEN 50 PERCENT, TO \$1.5 BILLION, WITH MOST OF THE INCREASE REFLECTING SHORT-TERM, GOVERNMENT-GUARANTEED CREDITS FOR THE MINING SECTOR.

4. THE PAYMENTS CRUNCH CARRIED INTO 1976 WHEN INTENSE AUSTERITY MEASURES WERE USED TO CUT THE CURRENT ACCOUNT DEFICIT TO \$137 MILLION. HALF THE IMPROVEMENT RESULTED FROM A 30-PERCENT CUT IN IMPORT VOLUME--ONE OF THE STEEPEST REDUCTIONS UNDERTAKEN BY ANY COUNTRY IN RECENT YEARS. A BRIEF REVIVAL IN COPPER PRICES IN EARLY 1976 ALSO HELPED, BOOSTING OVERSEAS SALES 29 PERCENT, TO ALMOST \$1 BILLION. WITH COPPER PRICES HOVERING AROUND 60 CENTS A POUND LAST YEAR, ZAMBIA WAS ABLE TO KEEP THE DEFICIT IN THE \$150 MILLION TO \$200 MILLION RANGE ONLY BY MAINTAINING A TIGHT LID ON IMPORTS; WHILE IMPORTS WERE CONSTANT IN VALUE TERMS, THEY FELL ROUGHLY 10 PERCENT IN VOLUME.

5. THE IMPORT RESTRAINTS OF 1976-77 CAUSED SEVERE SCARCITIES THROUGHOUT THE ECONOMY. SHORTAGES OF SPARE PARTS AND MATERIALS CAUSED TEMPORARY FACTORY CLOSINGS AND EVEN INTERFERED WITH MINE AND SMELTER OPERATIONS. THESE DISRUPTIONS LED TO A 4-PERCENT DECLINE IN REAL GNP LAST YEAR FOLLOWING UPON A MEAGER 1.6-PERCENT GAIN IN 1976. INFLATION REMAINED AT ABOUT 20 PERCENT, CUTTING SHARPLY INTO REAL WAGES.

THE 1978 CRUNCH AND IMF AID

6. DESPITE TWO YEARS OF AUSTERITY, ZAMBIA'S PAYMENTS PROBLEMS REACHED CRISES PROPORTIONS BY EARLY 1978. AT THE START OF THE YEAR, LUSAKA TECHNICALLY WAS IN DEFAULT ON AT LEAST ONE LOAN REPAYMENT DUE THE UNITED KINGDOM AND HAD FALLEN \$500 MILLION BEHIND IN PAYMENTS FOR IMPORTS. IN SOME CASES IMPORT PAYMENTS WERE 15 MONTHS BEHIND SCHEDULE. THE FINANCIAL SQUEEZE WAS ALSO INTERFERING WITH ZAMBIA'S ABILITY TO MEET SERVICE FEES ON USE OF RAIL AND PORT FACILITIES AT DAR ES SALAAM, WHICH HANDLES ALMOST ALL OF ZAMBIA'S FOREIGN TRADE.

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7. WITH AN EYE TOWARD OBTAINING IMF ASSISTANCE, LUSAKA IMPLEMENTED A NEW ROUND OF AUSTERITY MEASURES IN JANUARY. UNDER THIS PROGRAM, BUDGET OUTLAYS WILL BE HELD STEADY AT ABOUT \$1 BILLION WHILE REVENUES WILL BE INCREASED ENOUGH TO KEEP THE BUDGET DEFICIT TO \$300 MILLION. THE PROGRAM ALSO CALLS FOR CUTS IN CONSUMER SUBSIDIES, INCREASED TAXES ON A WIDE RANGE OF GOODS, AND A 5-PERCENT CEILING ON WAGE INCREASES. TO HELP PARE THE GOVERNMENT WAGE BILL, LUSAKA WILL MAKE ANOTHER EFFORT AT RELOCATING PUBLIC SECTOR EMPLOYEES TO FARMING, A MOVE WE DOUBT WILL HAVE MUCH SUCCESS.

8. IN CONJUNCTION WITH IMF GUIDELINES, LUSAKA HAS ALSO DEVALUED ITS CURRENCY 10 PERCENT, BRINGING THE TOTAL DEVALUATION SINCE MID-1976 TO ABOUT 30 PERCENT. IN RETURN, THE IMF HAS AGREED IN PRINCIPLE ON A \$360 MILLION LOAN TO BE DISBURSED IN NINE INSTALLMENTS OVER THE NEXT TWO YEARS. THE IMF HAS ALSO INCREASED ZAMBIA'S ACCESS TO THE IMF COMPENSATORY FINANCING FACILITY AND TO THE IMF TRUST FUND. ACCESS TO THESE FUNDS SHOULD ENABLE LUSAKA TO STAY ROUGHLY CURRENT WITH ITS EXTERNAL OBLIGATIONS AND PROVIDE SOME BREATHING SPACE TO RESCHEDULE PART OF THE SHORT-TERM DEBT RESPONSIBLE FOR THE CURRENT FINANCIAL PINCH.

9. IN THE ABSENCE OF RESCHEDULING, ZAMBIA WILL REQUIRE AN ESTIMATED \$350 MILLION IN 1978 TO COVER THE CURRENT ACCOUNT DEFICIT AND MEET DEBT REPAYMENT OBLIGATIONS. WITH COPPER PRICES REMAINING FLAT AND SHIPMENTS AVERAGING CLOSE TO LAST YEAR'S 650,000 TONS, THE CURRENT ACCOUNT DEFICIT WILL PROBABLY APPROXIMATE THE \$180 MILLION INCURRED IN 1977. WE ESTIMATE THAT DEBT AMORTIZATION COSTS IN 1978 SHOULD APPROACH \$170 MILLION; ADDITIONAL FUNDS WOULD BE NEEDED TO MAKE UP FOR IMPORT ARREARAGES.

BLEAK MEDIUM-TERM OUTLOOK

10. EVEN IF A DEBT STRETCH-OUT IS ACCOMPLISHED, ZAMBIA'S GENERAL ECONOMIC OUTLOOK IS POOR. SPENDING RESTRICTIONS ADOPTED TO WIN IMF HELP, IF ADHERED TO, WILL PREVENT APPRECIABLE REAL ECONOMIC GROWTH THIS YEAR, WHILE THE 10-PERCENT DEVALUATION WILL LIMIT PROGRESS IN SLOWING INFLATION. EXPANDED OUTSIDE ASSISTANCE COULD HELP FINANCE INCREASED IMPORTS FOR CONSUMPTION; ON ITS OWN, HOWEVER LUSAKA HAS LITTLE LEeway, ESPECIALLY SINCE FOREIGN EXCHANGE RESERVES HAVE DROPPED TO THE EQUIVALENT OF ONLY ONE MONTH'S IMPORTS.

11. ZAMBIA'S FINANCIAL STRAIGHTJACKET WILL REMAIN

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TIGHT UNLESS COPPER PRICES RISE. THE COPPER MARKET FOR AS FAR AHEAD AS WE CAN SEE WILL REMAIN FLAT SINCE (A) JAPANESE AND WEST EUROPEAN DEMAND REMAINS SLUGGISH; (B) WORLD COPPER STOCKS ARE AT RECORD LEVELS (2 MILLION TONS); AND (C) THE WORLD COPPER INDUSTRY HAS CONSIDERABLE SPARE CAPACITY. DIVISION AMONG MAJOR COPPER PRODUCERS HAS PREVENTED JOINT ACTION TO BOLSTER THE MARKET; AS MATTERS NOW STAND ZAMBIA'S COPPER MINES HAVE THE HIGHEST OPERATING COSTS OF ANY MAJOR PRODUCING COUNTRY AND HAVE BEEN RUNNING AT LARGE LOSSES SINCE 1976. WHILE THE DEVALUATION WILL DO LITTLE TO BOOST EXPORTS, IT WILL EASE THE COPPER INDUSTRY'S LOSSES.

12. GIVEN THE MAGNITUDE OF THE PAYMENTS PROBLEM AND THE POOR COPPER MARKET OUTLOOK, PRESIDENT KAUNDA IS FACED WITH GROWING POLITICAL OPPosition AND GRASS-ROOTS DISSATISFACTION CAUSED BY THE POOR STATE OF THE ECONOMY. KAUNDA'S CRITICS CITE SHORTAGES OF CONSUMER GOODS, RISING UNEMPLOYMENT, AND INFLATION AS MAJOR CAMPAIGN ISSUES IN THIS YEAR'S ELECTIONS. ALTHOUGH KAUNDA IS CERTAIN TO WIN AT THE POLLS, RESENTMENT OVER THE EROSION IN LIVING STANDARDS WILL CONTINUE. SO FAR THE MAJOR LOSERS HAVE BEEN THE LARGE NUMBERS OF WHITE EXPATRIATE WORKERS WHO ACCOUNT FOR MOST OF THE MANAGEMENT AND SKILLED LABOR IN INDUSTRY. AS A RESULT OF AUSTERITY AND LIMITS ON INCOME REPATRIATION, FEW ARE RENEWING CONTRACTS; FINDING REPLACEMENTS HAS BECOME INCREASINGLY DIFFICULT.

HOW RHODESIA FITS IN

13. KAUNDA'S SUPPORT FOR THE RHODESIAN GUERRILLAS, WHICH IS SEEN BY SOME ZAMBIAIS TO CONTRIBUTE TO THEIR ECONOMIC HARDSHIPS, ADDS TO POLITICAL PRESSURES. ALTHOUGH THESE PROBLEMS CLEARLY ARE OF CONCERN TO KAUNDA AS HE PLANS FOR THE ELECTIONS, THEY EVIDENTLY HAVE NOT WEAKENED HIS STAND AGAINST SMITH'S INTERNAL SETTLEMENT IN RHODESIA. FOR ONE THING, THE PRINCIPAL COST OF THE RHODESIAN CONFLICT TO ZAMBIA THUS FAR HAS BEEN THE POLITICAL AND MILITARY STRAIN RATHER THAN DIRECT ECONOMIC LOSSES. LUSAKA HAS ACTED AS A CONDUIT FOR FUNDS AND ARMS TO THE GUERRILLA FORCES, BUT THE ONLY DIRECT COST TO ZAMBIA HAS BEEN THE PROVISION OF SOME FACILITIES AND FOODSTUFFS.

14. THE PRESENCE OF 8,000 RHODESIAN GUERRILLAS IN ZAMBIA HAS HAD A DISRUPTIVE INFLUENCE GENERALLY BECAUSE OF PERIODIC INCIDENTS WITH CIVILIANS. THE PRESENCE OF THE INSURGENTS HAS ALSO PREVENTED ZAMBIA FROM SHAVING ITS OWN MILITARY SPENDING AT A TIME OF SEVERE AUSTERITY. MILITARY

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SPENDING NOW ACCOUNTS FOR 30 PERCENT OF THE BUDGET.

CONTINGENCIES AND OPTIONS

15. ZAMBIA'S ECONOMIC PROBLEMS BY THEMSELVES ARE NOT SERIOUS ENOUGH TO INDUCE KAUNDA TO ACCEPT IAN SMITH'S RHODESIAN SETTLEMENT. ANY SETTLEMENT, IN FACT, WOULD DO LITTLE TO ALLEVIATE LUSAKA'S ECONOMIC SITUATION, AND PARTICULARLY THE DEBT PROBLEM, UNLESS IT WERE ACCOMPANIED BY A LARGE INFLOW OF FOREIGN ASSISTANCE. WITHOUT SUCH AID, THE ONLY ECONOMIC GAIN OF CONSEQUENCE WOULD BE THE EASING OF POLITICAL AND MILITARY TENSIONS IN THE AREA. THIS WOULD NOT ADDRESS ZAMBIA'S BASIC PROBLEM, THE LOW PRICE OF COPPER. (ZAMBIA COULD NOT EXPECT TO RECAPTURE THE CLOSE INTERSTATE RELATIONS THAT EXISTED PRIOR TO RHODESIA'S UNILATERAL DECLARATION OF INDEPENDENCE IN 1965. FOR EXAMPLE, LUSAKA'S POLITICAL AND ECONOMIC INVESTMENT IN THE TAN ZAM RAILROAD WOULD PREVENT TRANSFERRING MUCH MORE THAN OVERFLOW FREIGHT TO THE RHODESIA/MOZAMBIQUE OUTLET. ALTHOUGH ZAMBIA PRODUCES LITTLE THAT RHODESIA WOULD WANT TO BUY, IT PROBABLY COULD FIND RHODESIA A CHEAPER SOURCE OF COAL AND OTHER INDUSTRIAL PURCHASES.)

16. AT THE OTHER EXTREME, AN INTENSIFICATION OF THE RHODESIAN CONFLICT WOULD FURTHER DARKEN ZAMBIA'S ECONOMIC PICTURE. INCREASED MILITARY ACTIVITY IN THE AREA WOULD ERODE THE ALREADY SHAKY CONFIDENCE OF PRIVATE CREDITORS AND WEAKEN ZAMBIA'S ABILITY TO RAISE NEW FUNDS ABROAD. IN THESE CIRCUMSTANCES, THE RISK OF LOAN DEFAULT WOULD BE SUBSTANTIALLY INCREASED, ALTHOUGH THE DAMAGE TO ZAMBIA'S CREDIT RATING WOULD LAST ONLY AS LONG AS THE CONFLICT ITSELF. PERHAPS THE MOST SERIOUS CONSEQUENCE OF AN EXPANDED CONFLICT WOULD BE THE ALMOST CERTAIN EXODUS OF WHITE EXPATRIATES. (CONFIDENTIAL)

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